



State Taxation of Partnerships – Report to the Work Group

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SOURCING INVESTMENT PARTNERSHIP INCOME

- Applies ONLY to Nonresident Individual Partners –
 - Resident partners pay tax on 100% of their income (with a credit for taxes paid to other states).
 - Corporations and pass-through partners source income applying state allocation and apportionment rules at the entity or unitary business level.
 - In comparison, states have specific rules for sourcing the income of nonresidents which look to the type of income and the type of asset.

SOURCING OF INVESTMENT PARTNERSHIP INCOME – OPTION 1

Entity Level Sourcing

- Use the default rule of sourcing partnership income which applies state allocation and apportionment rules at the partnership level.

OR

Residency Sourcing

- Source all the income of an investment partnership based on the residence of the partner.

SOURCING OF INVESTMENT PARTNERSHIP INCOME – OPTION 2

Entity Level Sourcing

- Use the default rule of sourcing partnership income which applies state allocation and apportionment rules at the partnership level.

OR

Look-Through Sourcing

- Ignore the investment partnership's activities when sourcing the income and look instead to the state sourcing rules applied as if the partner were engaging directly in the activities giving rise to the item of income.

OPTION 2 TREATMENT IS SUPPORTED BY EXISTING STATE SOURCING RULES:

1. States conform to Subchapter K's conduit approach.
2. States do not apply the federal sourcing rules to partnership items in the interstate context.
3. States source direct nonbusiness investment income of nonresidents using specific rules based on the type of income or asset.
4. States generally source partnership income using an entity approach.

WHY REGULATION FORM

Treatment is supported by existing state law.

The goal here is to provide greater certainty in certain fact-specific situations, which is what regulations are typically used for.

States that currently have explicit statutory provisions could also adopt the rule in regulation form.

And, unlike statutes, regulations may include examples, which would be very useful here.



GENERAL APPROACH

- The regulation, like the prior draft, does not apply to all investment partnership income.
- The general rule in Section 1 is restatement of the general principles above.
- “Qualified investment partnership” is defined generally.
- The safe harbor is formulated as a rebuttable presumption.
- Examples are used to illustrate application.

(a) General Rule.

Under the [reference to state's individual income tax], a nonresident partner's distributive share of partnership income is generally allocated and apportioned to this state at the partnership level based on the partnership's business or other activities in this state. See [insert reference to applicable statutes and regulations, including UDITPA if applicable, and to IRC § 702]. But the investment related activities of a qualified investment partnership in this state do not affect how certain nonresident partners source their distributive share of that partnership's investment income. Rather, the sourcing rules for nonresidents apply to the items of income making up the partner's distributive share from the qualified investment partnership as though the partner earned (or incurred) the items directly. See [reference to applicable statutes and regulations governing sourcing of income for nonresidents].

(b) Applicability to Certain Nonresident Partners.

This rule, which provides that the investment related activities of a qualified investment partnership in this state will not affect the sourcing of distributive share income from that partnership, applies to the partners of the qualified investment partnership who are nonresident individuals [and trusts and/or estates, if applicable], and therefore pay tax on a source basis to the state, and who do not actively engage in the management of the qualified investment partnership, including recruiting investors, overseeing investments, performing administrative functions, and similar activities.

(c) “Qualified Investment Partnership.”

A qualified investment partnership, as used in this regulation, means a partnership that:

- (1) does not act as a dealer under 26 U.S.C. § 475(c);
- (2) does not act as a financial institution as defined by [reference to state law]; and
- (3) holds assets solely for investment purposes and:
 - (i) does not materially participate or otherwise actively engage in the activities of the businesses in which it holds interests;
 - (ii) is not unitary with a business in which it holds interests; and
 - (iii) does not use or employ assets in any way other than for investment.

(d) Safe Harbor.

A partnership will be presumed to be a qualified investment partnership if, during the tax period in which the income is recognized, no less than 90 percent of the cost of the partnership's total assets consists of the following:

...[LIST OF INVESTMENTS] ...

[DRAFTER's NOTE: The state may wish to include other types of investments in this safe harbor provision to the extent their inclusion would be consistent with state sourcing rules generally.]

The presumption provided here is intended to act as a safe harbor and does not limit the application of the general rule provided in Section (c) of this regulation. The presumption provided by this Section (d) can be rebutted if the [state tax agency] can show that the investment partnership lacks economic substance or was put into place to evade tax.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(1) Simple Example:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- X has dividends from corporate stock.

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from investment in corporate stock recognized by an individual would be sourced to the individual's state of residence. [Insert reference to statutes and regulations.]

Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(2) Partnership X Meets General Criteria but not Safe Harbor:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has dividends from corporate stock.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from corporate stock recognized by an individual would be sourced to the individual's state of residence. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(3) Partnership X has Gain from Sale of Real Property in this State:

- Partner Smith owns an interest in Partnership X.
- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has a capital gain from the sale of real property in this state.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. As such, the activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, under state statutes and regulations, such capital gains from real property in the state that are recognized by an individual would be sourced to this state. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the capital gains is sourced to this state.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(3) Partnership X has Gain from Sale of Real Property in this State (continued):

If X were found not to meet the definition of a qualified investment partnership under Section (c), then X's activities in the state might affect the sourcing of the gain from the sale of real property. If the gain were determined to be part of X's unitary business, then the gain would be apportioned as part of X's business income using [reference to state's apportionment rules applied to partnerships]. If the gain were determined to be nonbusiness [or nonapportionable] income of X, then the gain would be allocated under [reference to state's rules for sourcing nonbusiness income].

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(4) Partnership has in Distributive Share Income from Another Partnership:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has distributive share income from an interest in Partnership Y, doing business in this state.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, under state statutes and regulations, such distributive share income recognized by an individual would be sourced to this state based on the activities of Partnership Y. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share of the income of Partnership Y, flowing through Partnership X, is sourced to this state based on the activities of Partnership Y.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(5) Partnership X is a Qualified Investment Partnership but Smith is a Dealer:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- Smith acts as a dealer in investments and has customers in this state.

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, Smith's investment in X would be considered part of the inventory of assets with respect to which Smith acts as a dealer. [Insert reference to statutes and regulations.] Therefore, Smith's distributive share from X is sourced to this state as part of the income of Smith's business as a dealer in this state.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(6) Smith Uses Investment in Partnership X in Another Business:

- Smith meets the criteria of Section (b) of this regulation.
- X meets the safe harbor of Section (d) of this regulation.
- Smith operates Business Y, a sole proprietorship, in this state.
- Under state statutes and regulations, Smith's investment in X would be considered part of the business income of Business Y. [Insert reference to statutes and regulations.]

The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, the distributive share from X would be sourced to this state as part of the income of Business Y.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(7) Smith Participates in the Management of the Qualified Investment Partnership:

- Smith is a minority partner but participates in the management of X and receives a carried interest (profits interest) for the services Smith performs.
- X has dividends from corporate stock.

Because Smith is engaging in the management of X, Smith's distributive share of income from X, including the share of dividends from corporate stock, is allocated and apportioned to this state based on the activities of X in this state.

(e) Examples. General Assumptions:

In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.

(8) Smith Owns a Share of an S Corporation which Owns an Interest in Partnership X.

Because the partner in this case, the S corporation, does not meet the criteria of Section (b) of this regulation, this regulation does not apply. Instead sourcing rules under [reference to sourcing of S Corporation income] would apply.